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CENTRAL INTELLIGENCE AGENCY
WASHINGTON, D.C. 20505

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19 September 1974

MEMORANDUM FOR: Mr. John MacCracken
Senior Advisor for Europe
Office of National Security
Department of the Treasury

SUBJECT : Background Information for President Leone's Visit

1. Attached is a short discussion of Italy's economic problems and outlook in response to your telephone request of 19 September.

2. If you have any questions concerning the paper, please call [redacted]

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[redacted]

Office of Economic Research

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Attachment: a/s

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THE ITALIAN ECONOMY: MAMMOTH PROBLEMS

INTRODUCTION

1. Italy is currently experiencing its most serious economic and financial crisis of the postwar period. Inflation is the worst in recent Italian history and the highest in the EC. The balance-of-payments deficit in the first 7 months of 1974 reached $6.3 billion, the equivalent of 5% of GNP, and may climb as high as $10 billion by year's end. Foreign exchange reserves are perilously low and private credit facilities virtually exhausted.

2. To cut the deficit and slow inflation, the government has been forced to adopt an austerity program that will worsen unemployment and sharply curtail economic growth. It has also obtained a $2 billion loan from West Germany and is angling for long-term assistance from other official sources. Despite these measures, financing the payments deficit over the next year or so poses a formidable problem for the Rumor government.

RECENT TRENDS

3. Thanks to a "truce" with labor and expansionary monetary and fiscal policies, Rome brought the Italian

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economy out of a long recession in 1973. Real GNP increased 5.4%, with growth concentrated in the second half of the year following the drop-off in strike activity. Growth slowed to about 2% in the first half of 1974, however, as investment and export growth declined. At the same time, inflation accelerated because of hefty wage increases, a rising budget deficit, and skyrocketing prices for oil and other primary commodities. The rate of increase hit about 50% for wholesale prices and 20% for consumer prices.

4. Buoyant domestic demand in 1973 and early 1974 stimulated imports, especially of capital equipment and quality consumer goods. Late in this period, a steep rise in prices for crude oil and other imports accelerated the deterioration in the trade balance. The deficit jumped from $1.7 billion in the first half of 1973 to $4.0 billion in the first half of 1974. Mounting capital outflows induced partly by domestic political uncertainties added to the payments problem. Because of the resulting rapid buildup in foreign debt, huge foreign exchange losses, and bad credit rating, Italy found itself on the verge of bankruptcy in international financial markets.

GOVERNMENT POLICY SHIFTS TO AUSTERITY

5. Its balance-of-payments difficulties have forced Rome to shift its priorities in recent months. Since early 1974, cutting the trade deficit and reducing inflation have become more important policy objectives than economic growth. Because of labor opposition and fear that the lira would decline to an unacceptable level, Rome decided against trying to improve the trade account by allowing the lira to depreciate through a "clean float". Instead, the government imposed controls on capital outflows and implemented a prior-import-deposit scheme designed to curb imports and reduce domestic liquidity. Rome has promised the IMF that it will lift its import deposit requirements by March 1975.

6. The government backed up these direct controls with a program of domestic austerity. The fiscal and monetary measures it adopted are the result of a political compromise. The Christian Democrats favored tougher measures to curb import demand and inflation, while the Socialists wished to avoid threats to employment and to social-welfare spending. The measures are probably the most stringent now politically feasible in Italy and are certainly more comprehensive than those taken by any other West European country to deal with payments problems.

7. Initially, the main adjustment burden fell on monetary policy. The Bank of Italy imposed a 15% ceiling on growth of bank credit, allowed interest rates to rise sharply, and -- more recently -- curbed commercial bank borrowing from abroad. It also strictly limited support to the bond market, thereby drying up a traditional source of funds for special credit institutions. The money supply, narrowly defined, is still expected to expand at an annual rate of about 18% in the second half of this year and about 15% in the first half of next year. Credit will be tight, however, because growth will lag behind the rise in nominal income and government borrowing requirements will remain high.

8. Fiscal policy was tightened considerably in August, when the government's new austerity program was officially adopted after considerable amendment to appease the Socialists, Communists, and labor unions. The program is designed to increase fiscal receipts by about $4.5 billion -- some 3% of GNP -- thus cutting into domestic demand appreciably. The fiscal package includes increases in some public service rates, in contributions to national health insurance schemes, in value-added taxes on luxury goods and some meats, and in corporate income tax rates. A one-time surcharge on personal

incomes of over $15,000 also was levied. Most of the additional revenue will be used to reduce the budget deficit from a projected $14 billion to closer to last year's $12 billion level.

The Austerity Program's Impact

9. The Rumor government's austerity program should ease pressures on the balance of payments over the next year or so, but it probably will also bring the economy to a virtual standstill. Restrictive fiscal and monetary policies will depress investment and private consumption; export growth is expected to barely offset this drop in domestic demand. As a result, we estimate that real output will grow by less than 1% through mid-1975. Unemployment will rise during the period, hitting perhaps as high as 6% of the labor force.

10. The expected drop in domestic demand, together with past lira depreciation, should allow Italy to improve its trade account appreciably in the months ahead. Export volume probably will grow at an annual rate of 10% in the current half-year and at 7% or so in the first half of 1975. We expect import volume to decline at a 4% rate in the second half of 1974, because of the austerity program

and the continuing impact of the prior-import-deposit scheme, and then to recover by only 1% or so in the next half year. Improving terms of trade will also help to reduce the six-month trade deficit to an estimated $2.6 billion by the first half of 1975 -- a still troublesome level but considerably below the record hit in the first six months of this year.

11. Despite the government's shift to more restrictive policies, prices almost certainly will continue to increase rapidly during the next year. The increase in value-added taxes included in the austerity program will directly raise consumer prices in the short-run. Inflation, in turn, will trigger automatic upward adjustments in wages and larger negotiated wage hikes. Manufacturers can be expected to pass the increase in labor and other production costs on to consumers rather than cut already depressed profits. As a result, prices probably will rise by somewhat more than 20% between mid-1974 and mid-1975.

Borrowing Efforts

12. To cover the balance-of-payments deficit through July, Rome arranged for $2.3 billion in Eurodollar loans, a $1.9 billion short-term credit from the EC, and $1.5 billion in short-term commercial bank loans from abroad.

It also drew down net central bank assets by $0.6 billion. More recently, it drew $322 million on its IMF tranche and $300 million on its stand-by credit. Rome has also obtained a $315 million credit from the new IMF oil facility.

13. Because its poor credit rating virtually precludes borrowing in private financial markets, Rome is seeking foreign official assistance to cover the balance-of-payments deficit expected during the rest of this year -- possibly several billion dollars -- and in 1975. Thanks in part to its new austerity program, Rome recently succeeded in obtaining a $2 billion loan from the West German Bundesbank. This loan, which Rome must back with about 600 tons of gold valued at a market-related price, will be renewable at six-month intervals for up to two years. Bonn also supported Italy's recent successful effort to gain a three-month extension on repayment of the $1.9 billion in short-term credits that fell due this month. In the Schmidt government's view, Italy should be the primary -- if not the sole -- beneficiary should the EC agree to float a joint loan on the international market to assist member countries in payments difficulties.

14. Rome will still have to obtain additional loans, particularly if it hopes to avoid substantial lira depreciation. A political crisis this fall could increase pressure on the lira up to last spring's level, when the central bank paid out $50 million daily in support. If so Italy's current reserve resources -- excluding gold but including the German loan -- would last for only three or four months.

UNCERTAINTIES

15. All short-term economic forecasts for Italy should be viewed with skepticism. They are based on a very slim data base for the first half of 1974. Moreover, serious labor unrest or political difficulties may reappear. Union decisions to strike in protest over rising prices and unemployment would cut production, lower exports, and encourage capital flight, and considerably worsen the investment outlook. Renewed government instability also would depress investment and encourage capital outflow.

16. Other factors could cause estimated and actual patterns of investment and exports to diverge still further. Because there are no good indicators of investor plans, investment could fall substantially more than indicated. Exports could increase more slowly than anticipated, particularly if foreign demand for Italian goods grows less rapidly than now expected.

17. Rome's ability to continue financing a large -- if declining -- trade deficit is another major uncertainty. If the government is unable to obtain foreign loans on acceptable terms, it probably will be forced to let the lira depreciate further later in the year and to restrict imports. A lira depreciation would worsen Italy's short-term prospects for inflation and the import bill.

18. Finally, political pressures may force the government to relax its restrictive policies before the end of 1974. The trade unions may yet balk at the higher taxes recently imposed, even though upper-income groups bear a larger share of the increased burden. They -- like private business -- will continue to press for a relaxation in credit restrictions to avoid increased unemployment. To keep labor peace, the government may be forced to accede to these pressures long before its price and balance-of-payments objectives are realized.

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19 September 1974

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TABLE 1

ITALY--SOURCES OF GROWTH

Million 1972 Dollars[1] and Percent Change[2]

			Estimated	Projected	
	First Half 1973	Second Half 1973	First Half 1974	Second Half 1974	First Half 1975
Private Consumption	78,828 (7.0)	81,137 (5.9)	83,200 (5.1)	82,535 (-1.6)	82,865 (0.8)
Government Consumption	17,892 (2.6)	18,118 (2.5)	18,432 (3.5)	18,525 (1.0)	18,526 (0.0)
Gross Fixed Capital Formation	23,946 (5.1)	26,157 (19.3)	26,890 (5.7)	26,729 (-1.2)	26,190 (-4.0)
Change in Inventories	2,762	1,277	1,300	900	900
Total Domestic Demand	123,428 (8.5)	126,689 (5.3)	129,822 (5.0)	128,689 (-1.8)	128,481 (-0.4)
Exports	17,611 (-18.8)	21,344 (46.9)	21,566 (2.2)	22,621 (10.0)	23,399 (7.0)
Imports	-20,249 (12.6)	-21,703 (14.9)	-22,029 (3.0)	21,588 (-4.0)	21,696 (1.0)
Net Foreign Demand for Goods and Services	-1,222	1,318	263	733	1,453
GNP	122,206 (4.2)	128,024 (9.7)	129,157 (1.8)	129,422 (0.4)	129,834 (0.6)

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[1]Dollar values were obtained by converting at the average 1972 exchange rate of 583.27 lire = 1 US dollar.

[2]Change from the preceding half-year, at annual rates.

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TABLE 2

ITALY--CURRENT ACCOUNT

Million Current US $[1] and Percent Change[2]

	First Half 1973	Second Half 1973	First Half 1974	Second Half 1974	First Half 1975
Trends in Value					
Exports (f.o.b.)	9,550 (1.2)	12,550 (72.7)	13,600 (17.5)	15,275 (26.1)	1,634 (3.8)
Imports (f.o.b.)	11,220 (32.7)	14,840 (75.0)	17,565 (40.1)	18,295 (8.5)	1,190 (1.1)
Trade Balance	-1,670	-2,290	-3,965	-3,020	-2,556
Current Account Balance	-826	-1,705	-4,315	-3,370	-2,906
Trends in Trade Volume and Prices					
Export Volume	-18.8	46.9	2.2	10.0	7.0
Export Prices	26.4	17.6	15.0	15.0	11.0
Import Volume	12.6	14.9	3.0	-4.0	1.0
Import Prices	18.8	56.3	35.0	13.0	9.0

CIA/OER
19 September 1974

[1]Seasonally adjusted; values converted into dollar exchange rates: first half 73, 584.70; second half 73, 581.28; first half 74, 641.8; second half 74, 650.0; first half 75, 650.0.

[2]Change from preceding half-year, at annual rates.